Planning and Documenting Charitable Gifts

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Many of today's donors desire to designate their charitable contributions for specific purposes or to impose other conditions on their gifts. Such conditions and restrictions are usually well-intended, but careful thought and planning are required to ensure these limitations do not endanger the deductibility of the contribution by the donor while ensuring proper use of the gift by the charity.

Conditions and Restrictions

A contribution is deductible only if it is made "to or for the use of" a charitable organization under Code § 170(a). A donor may earmark a contribution to charity for a particular use without jeopardizing the charitable deduction, provided the restriction does not prevent the charity from freely using the transferred assets, or, at a minimum, the income therefrom, in furtherance of its charitable purposes. If the gift is earmarked for a noncharitable purpose, or even a charitable purpose that is outside of the donee organization's charitable mission, the gift is not deductible. Treas. Reg. § 1.170A-1(e) provides examples of permissible restrictions, including the contribution of land to a city to be used as a public park, when the city intends to use the land for such purpose at the time of the gift; the creation of an endowment fund for a particular university department; and the donation of funds for the construction of a building sought to be built by an exempt organization.

If a restriction or condition is placed on a gift, it must be done at the time of the gift. Otherwise, the retained right to place conditions on the property after the gift could render the gift incomplete. A donor, however, can retain the right to make nonbinding recommendations regarding the distribution of previ-

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ously contributed property. This is why contributions to donor-advised funds that allow post-gift recommendations are fully deductible.

Reverter Clauses

Reverter clauses are sometimes used by donors to ensure their gift conditions are followed. For example, in the city park example above, if the city ceased to use the donated property as a public park, the gift agreement or deed of gift might have provided that ownership of the land would revert back to the donor's family. Such reversionary provisions must be used with caution because they will cause the charitable transfer to be nondeductible unless the reversion is "so remote as to be negligible." Treas. Reg. § 20.2055–2(b)(1). In *Briggs v. Commissioner,* 72 T.C. 646 (1979), the Tax Court defined "so remote as to be negligible" as a "chance which persons generally would disregard as so highly improbable that it might be ignored with reasonable safety in undertaking a serious business transaction" and "so highly improbable and remote as to be lacking in reason and substance."

In Rev. Rul. 2003-28, 2003-11 I.R.B. 594, an individual transferred a patent to an educational institution on the condition that a designated faculty member remain on the faculty during the patent's 15 years of remaining life. The IRS determined that the possibility that the faculty member might not remain was not so remote as to be negligible. Therefore, no charitable deduction was allowed. On the other hand, the city park example illustrates that when the circumstances at the time of the gift indicate a strong likelihood that there will be no reversion, the charitable deduction will be permitted.

Conditions Precedent

A charitable deduction will also be disallowed if a transfer is dependent on the performance of some act or the happening of an event before the transfer becomes effective, unless the possibility that the event will not occur meets the "so remote as to be negligible" test.

In Rev. Rul. 79-249, 1979-2 C.B. 104, a gift to a public school system to build a school contained a reverter clause if the remaining funds were not raised to complete the project. The IRS ruled that until it was certain there were adequate funds to construct the building, the possibility the donation would be returned to the donor was not so remote as to be negligible. Therefore, the deduction had to be deferred by the donor until it was clear that the building would be constructed.

Benefiting Individuals

To be deductible, a donation must be "to or for the use of" a charitable organization, not a designated individual, no matter how deserving the individual may be. A donor cannot avoid this result by flowing his or her contribution through a charitable organization and earmarking a gift for a particular individual.

The IRS uses two tests to determine if a gift is earmarked and therefore nondeductible:

1. *Does the donee organization have discretion and control over the contribution notwithstanding the donor's desire to benefit a specific individual?* If the charity has the option to apply the donated funds to other purposes, this supports deductibility of the contribution.
2. *Does the donor intend to benefit the charitable organization or the designated individual?* A written agreement between the donor and donee provides the clearest evidence of how each side understands its rights and responsibilities. In addition to a gift agreement or correspondence between the donor and the donee organization, the donee organization's fund-raising literature and the donor's receipt for the gift will be considered by the IRS in determining whether an earmarked gift is made.

A number of cases and rulings involve family members who desire to provide funds for a relative's living expenses while doing missionary work. If the gift is earmarked, the charitable deduction is denied. Facts that have supported a deductible gift include statements in the missionary organization's fund-raising material that the organization retains full discretion over the donated funds and will assess all of its current needs before distributing any funds.

To ensure deductibility, the IRS suggests the following language in the donor's receipt: "This contribution is made with the understanding that the donee organization has complete control and administration over the use of the donated funds." Donors should consider including such language in their gift transmittal letter and donee organizations' fund-raising materials and gift receipts ought to contain similar language to bolster the deductibility of contributions.

Artwork

In a series of 2002 private letter rulings, the IRS highlighted the special issues that must be considered when placing restrictions on gifts of art and other collectibles. In these rulings, the donor bequeathed paintings to a museum, subject to conditions, including their continuous display and the requirement that the proceeds from the sale of any of the works be used to purchase other works of art. The IRS allowed the charitable deduction because the only limitation on the museum's sale of the art was a requirement that it purchase other works of art with the proceeds.

Restrictions on deaccessioning, including required holding periods before the sale of donated artwork, are more troublesome and can negatively affect the amount of the donor's charitable deduction. For example, collectors Samuel and Norma Silverman contributed 148 paintings to various exempt organizations with the restriction that the paintings could not be sold for three years. The Tax Court found that the Silvermans were entitled to an income tax charitable deduction, but the three-year restriction had an adverse effect on the value of the paintings and reduced the charitable deduction. *Silverman v. Commissioner*, 27 T.C.M. (CCH) 1066 (1968).

In PLR 200418002, a husband and wife amassed an important art collection that was housed in a gallery attached to their home. The couple planned to bequeath their home, gallery, and funds sufficient to maintain the facilities to a museum.

The couple entered into an agreement with the museum to transfer the collection to the museum at the last of their deaths, subject to certain conditions. The museum agreed to display the collection permanently at either the gallery or the museum. The agreement prevented the museum from selling, transferring, or disposing of any of the works. In the event the museum did attempt to sell any pieces from the collection, ownership immediately and automatically vested in the donors' private foundation.

In this case, the IRS ruled that because the collection would not under any circumstances revert to the donors or inure to the benefit of any private individuals, the value of the charitable deduction would be equal to the collection's estate tax value included in the donors' gross estate for estate tax purposes.

Naming Opportunities

Many donors desire to establish lasting memorials through the funding of named scholarship funds, professorships, or capital projects. So long as these gifts further the organization's charitable mission, the deductibility of a gift conditioned on the naming opportunity should not be questioned. Recent corporate scandals, however, serve as a reminder that exempt organizations must protect their integrity by establishing "un-naming" policies and procedures in their gift acceptance policies or gift agreements to address unexpected future developments.

For example, it is unclear what will become of the University of Alabama–Birmingham's Scrushy Hall, named after the dethroned CEO of HealthSouth, or the University of Missouri–Columbia's professorship named after former Enron CEO Kenneth Lay. Absent un-naming rights in the gift agreement or gift acceptance policy, the donee organization may not be able to remove the donor's name, or may be required to return the contribution if it does.

Investment Management

In PLRs 200445023 and 200445024, the IRS ruled that a donor's retention of the right to manage the portfolio of publicly traded securities given to charity would not preclude the donor's income and gift tax charitable deductions. In these two rulings, the donors gave cash and marketable securities to a college, subject to an agreement that the gifted assets be placed in a brokerage account in the name of the charity for its exclusive benefit, with management authority retained by the donors. The account could be invested only in U.S. equities, mutual funds and fixed-income securities, offshore/onshore hedge funds, real estate investment trusts, and private placements and could not be invested in any company in which a donor held, directly or indirectly, more than 5% of the stock. The college could withdraw the assets from the accounts or terminate the management agreement at any time. If not earlier terminated, the management agreement would end in 10 years. The IRS determined that the donors retained no economic interest in or power to direct the beneficial enjoyment of the accounts and that their investment management control, as limited in these facts, did not preclude an income or gift tax charitable deduction.

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Valuation

Generally, the amount of an income or estate tax charitable deduction is equal to the contributed property's fair market value on the date of the gift or bequest. If a donor places a restriction on the marketability or use of the contributed property, the charitable deduction must be reduced to take the restriction into account.

Rev. Rul. 2003-28, 2003-11 I.R.B. 594, discussed above, also addressed the deductibility of the contribution of a patent that the donee was prohibited from selling for three years. The IRS ruled that although the three-year sale prohibition could never cause the patent to revert to the donor, or otherwise benefit the donor, the restriction reduced the fair market value of the patent and the donor's corresponding charitable deduction.

In Rev. Rul. 85-99, 1985-2 C.B. 83, an agricultural college sought to acquire a parcel of land for research purposes. A landowner agreed to donate the property and did so by deed containing a restrictive covenant limiting the land's use to agricultural purposes. Although the highest and best use of the land was commercial development, the IRS ruled that the income tax deduction must be determined in light of the restriction, not based on highest and best use. A very similar conclusion was reached in PLR 8641017, in which a donor restricted mining on property in the deed conveying it to an exempt organization. In both cases, the donor could have received a significantly greater deduction by first granting a conservation easement to restrict development or commercial activity on the land, then contributing the property, subject to the easement, to the exempt organization.

When evaluating gift restrictions, advisors also must consider the significantly different outcomes in inter vivos and testamentary gift situations. Although a donor's income tax deduction will be reduced if a lifetime gift is deemed to have restrictions affecting valuation, a particularly bad result arises if the donor owns fee simple title to property at death but places restrictions in the testamentary charitable gift of the property that reduces its fair market value. In that case, the estate tax charitable deduction may be significantly below the property's value for estate tax purposes. Rather than jeopardize the value of a charitable deduction, donors should consider whether precatory language expressing their wishes regarding the donated property will achieve the desired result.

Standing to Enforce

Once a gift is complete, courts have historically held that the donor no longer has standing to enforce the terms of the charitable gift. Instead, this right inures to the benefit of the public, usually enforceable by the state attorney general's office.

That began to change in 2001 when a New York State appellate court ruled that Adele Smithers-Fornaci, the personal representative of her late husband's estate, could sue St. Luke's-Roosevelt Hospital Center for failing to abide by the terms of her husband's $10 million, 30-year-old gift. *Smithers v. St. Luke's-Roosevelt Hospital Center*, 723 N.Y.S.2d 426 (App. Div. 2001). In *Smithers,* Mrs. Smithers-Fornaci alleged that St. Luke's had misappropriated $5 million from her husband's endowment fund and planned to put the proceeds from the sale of a townhouse, also given by her husband, into its general operating funds. The New York court held that the donor's estate had standing to sue St. Luke's to enforce the terms of the gifts. Since *Smithers,* some courts have opened to the idea that donors, their estates, or their descendants have the right to rescind gifts or to take legal action if gift conditions are not honored.

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In another case, Sybil Harrington, a wealthy Texas oil businesswoman, gave $33 million to the Metropolitan Opera to support opera "in the traditional manner." The Met used part of her gift to televise an abstract Wagner production. Relying on *Smithers,* Harrington's estate sued the Met to recoup the funds expended on its television production and to obtain veto power over how the remaining funds were spent.

In 1996, Paul Glenn's Foundation for Medical Research donated $1.6 million to the University of Southern California for the study of aging. Glenn sued USC in 2001, alleging that it did not honor its oral and written contracts. This case received significant media attention and reaffirmed the post-*Smithers* trend of allowing private legal action when charitable gifts do not turn out as planned.

Although these recent cases have begun to alter the traditional concept that the donor has no standing to sue, these decisions are quite new and not the law in every jurisdiction. As such, donors may seek to create standing to enforce their gifts by including provisions in their gift agreement giving themselves, their estate, or some other identifiable party the power to enforce the gift.

Using Gift Agreements

Many of the practical and tax problems discussed above can be addressed or eliminated in a well-drafted gift agreement signed by the donor and donee at the time of the gift. Ideally, the gift agreement will ensure:

- The donor's wishes are clearly understood and articulated.
- Changes in circumstances are anticipated and addressed, including:

  —The potential conflict between a donor's desire for specificity and the donee's desire for flexibility.
  —Mandatory alternative uses are a modern alternative to the old-fashioned reversionary provisions. Sample language might include:

  > "If due to changed circumstances it is impracticable to carry out the above purpose, the gift will be used for. . . :
  > —[specific alternative use]
  > —purposes as nearly as possible akin to the original purpose as possible."

  —A donor can even specify another charitable organization as an alternative beneficiary if the gift conditions are not met.
  —Most testamentary donors may be satisfied with precatory language ("It is my wish. . . ").
  —Buildings do not last forever, so what happens to the donor's name? More progressive donors should consider permitting the charity to allow alternate uses after a fixed period of time.

- For deferred gifts, it is important for the written gift agreement to address the following issues:

  —Enforceability of the pledge.
  —A specific payment schedule.
  —Whether naming will be withheld until gift completion.
  —Whether the name can be removed if the gift is not completed or if the donor gets into trouble.
  —Who pays for project cost overruns.
  —Clarification the donor's wishes regarding confidentiality of donor and amount of gift. Consider how state sunshine laws apply if confidentiality is desired by the donor or the charity.
  —The Uniform Management of Institutional Funds Act (UMIFA) governs the management of many endowed funds. The donor should understand the provisions of UMIFA and how it may affect the use of the contributed funds.
  —All too many agreements are drafted by nonlawyers, such as development officers, and fail to address basic contract issues, such as

  - the governing law,
  - that the agreement may be amended only in writing signed by authorized

persons, and
- that the written agreement is the entire agreement between the parties.

Gift Acceptance Policies

Many exempt organizations need to update their gift acceptance policies to establish criteria for all naming opportunities and for the removal of names from endowment funds, buildings, and so on. Donors and their advisors should look for provisions that address

- what happens 30 years from now if the named building is demolished or completely renovated, and
- what rights the charity has if the donor goes to jail or defaults on its pledge.

Professional Ethics

Attorneys who render charitable planning advice must be ever mindful that charitable gift planning is governed by the same rules of professional conduct as other areas of law practice.

Oregon Formal Ethics Opinion No. 1991-116 (subsequently readopted as Formal Opinion 2005-116) involved a very typical fact pattern. The attorney was a long-serving member of the charitable organization's board of directors and had provided legal advice to the organization on a continuing basis. An individual donor, likely a fellow board member, asked the attorney to represent the donor and the donor's spouse in two estate planning projects: an inter vivos charitable remainder trust in which the charitable organization would be the remainder beneficiary and the preparation of wills under which the charity also would be one of the beneficiaries.

The Oregon Ethics Opinion specifically addressed three questions:

1. *May the attorney represent both the donors and the charity in the charitable remainder trust transaction?*
   No. Because of the potential differing interests or positions between the charity and the donors concerning the terms of the transaction, representation of both the charity and donors in this CRT transaction would constitute a conflict of interest.
2. *May the attorney represent only the donors in the CRT transaction?*
   Yes. With full disclosure and the consent of both the charity and the donors.
3. *May the attorney prepare the donors' wills?*
   Yes. With full disclosure to and consent from the donors. The consent of the charity was not required in this situation because its interests were deemed not to be adverse under this document, unlike the charitable remainder trust transaction.

In Maryland Ethics Docket 2003-08, the Committee on Ethics of the Maryland State Bar Association ruled that a lawyer who encourages parishioners of his church to leave bequests to the church in their wills may not also prepare their wills because of Rule 1.7 of the Maryland Rules of Professional Conduct governing conflicts of interest. This rule (which is similar to Rule 1.7 of the ABA Model Rules of Professional Conduct) prohibits a lawyer from representing a client if that representation will be directly adverse to another client or may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interest.

In this situation, the lawyer chaired the church's development committee and offered to prepare estate planning documents on a pro bono basis for church members interested in leaving bequests to the church. The Maryland Committee on Ethics ruled that the lawyer's interest in helping his church's planned giving efforts compromised his independent professional judgment. The lawyer could not represent both the interest of the client and the development committee at the same time.

Attorneys, and other professional advisors, with ties to charitable organizations must carefully evaluate their relationships with the organization to determine whether it creates a conflict of interest or concerns about undue influence with a prospective client who is considering gifts or other transactions with the charitable organization. Full disclosure of the advisor's relationship with the charitable organization, in writing, is well advised. The advisor also might consider obtaining a written acknowledgement and waiver of any potential conflicts.

Conclusion

Planned giving advisors must be sensitive to the new breed of donors and their desire to control or restrict their charitable gifts. Many of these desires can be addressed in a well-drafted charitable gift agreement. Failure to properly design and restrict donor control and gift restrictions, however, can cause practical and tax implications that both the donor and the charitable recipient would like to avoid. ■